Five Mile River Investment Management, LLC October 25, 2021
Client Quarterly Letter
3rd Quarter 2021

PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	**Retirement**	**Industrial**	**Dividends***
2021 Q1	6.48%	6.72%	8.29%	6.17%
2021 Q2	9.00%	8.32%	5.08%	8.55%
2021 Q3	-2.90%	-2.60%	-1.46%	0.58%
2021 YTD	**12.71%**	**12.59%**	**12.12%**	**15.92%**

The S&P 500 reached +21% year-to-date on September 2nd before correcting 6% later in September and early October. Profit taking, after such a long upward climb and elevated stock valuations, is normal market behavior. After this September pullback, the S&P 500 is, as of mid-October, back up to +21%, as confidence remains in the Federal Reserve's stimulative monetary policy evident over the last two years. The fact that Federal Reserve Chairman Jeremy Powell has vocally telegraphed a very consistent Federal Reserve policy has enabled the stock and bond markets to look past many economic and international potholes.

The FMR 2020 year-end report published this past January projected a forecast for equity returns in 2021 of a conservative +8% to +10% with a target for the S&P of 4100. Currently the S&P 500 is just over 4500. What has fueled this return? The drivers have been investor enthusiasm for the robust quarterly earnings comparisons anticipated in 2021, coupled with virtually 0% interest rates guaranteed by the Fed. These conditions were the primary fuel for the continued market recovery in price earnings ratios for the dominant companies in almost every industry sector. Record price earnings ratios ranging from 20X to as much as 50X, are commonplace. Finance and energy companies are the main exception to over-valuation which is one of the reasons we have significant weighting in these two sectors.

With these unusually high valuations, 5% to 10% corrections, as mentioned earlier, are normal after such a pronounced upward move. The caveat in this unusual and unprecedented year of COVID recovery is that the consumer is still flush with cash from a much higher savings rate, and obvious to us all, the demand for goods and labor is higher than the supply across almost all sectors and product lines.

The Five Mile River (FMR) July letter postulated that inflation was going to be a problem, exacerbated by the Fed's failure to slow or to stop their massive government and mortgage bond buying. FMR's strong belief that inflation is not transitory, to use the Fed's terminology, was discussed in the Five Mile River (FMR) 2Q Client Letter. Raising the 0% fed funds rate should have started this past summer. Why? Continuing to flood the economy with trillions of dollars in monetary stimulus triggers inflation. In just the two past years, the purchase of over $2 trillion of government debt and mortgage-backed securities, now on the Fed's balance sheet, is unprecedented! Combine that monetary stimulus with trillions of dollars in needed COVID aid and then potential trillions more in both real infrastructure ($300B to $400B) and social infrastructure spending presents abundant fuel for rising inflation.

INFLATION

Current year-over-year inflation, as measured by the Consumer Price Index (CPI), has been running 5%+ (annual rate) for the past several months and may well reach an annual rate of 6%+ to 7%+ over the coming months. Conversely, the Fed uses a different index from the CPI called the Personal Consumption Expenditure Deflator (PCE Deflator). As a result, the Board of Governors of the Federal Reserve, along with

Chair Jeremy Powell, have consistently underestimated the inflationary pressures this year by favoring the PCE Deflator, and putting little weight in the real-life, on-the-ground inflation. Very recently but belatedly, several Fed governors are now recognizing that they will have to stop tapering and raise rates in response to real inflation.

WHAT IS REAL-LIFE INFLATION?

Obviously home sale prices are contributing to real-life inflation. We have witnessed a wild upward swing in home sale prices, up more than 20% year-over-year in many markets. In contrast, rental rates went down in 2020, and for several years prior to 2020, rental rates rose on average only 2% to 3% per year! Measuring housing inflation is unfortunately underestimated in both the PCE and the CPI. The PCE uses something called "equivalent rent" for calculating the rate of rising house values as equivalent to the slower increase in cost of an apartment rental. The result is that housing price inflation is tempered and not captured in the PCE. This is another reason the Fed has been behind the curve in addressing inflationary risk.

Huge underestimation of healthcare costs, along with rising food and energy costs, also explains FMR's assessment that the Fed is behind the inflation curve. Oil and natural gas prices are at recent record highs having doubled in the last year. There has been a dramatic increase of Brent Crude prices in Asia, Europe, and the U.S., with prices rising to $85.00/barrel, a level not reached since late 2018. The U.S. natural gas prices are now over $5.00/million BTUs, up from a low of $2.63/million BTUs in 2019. Heating costs in the U.S. are estimated to rise by 30% to 40% this winter. These are all real-life inflation factors affecting the vast majority of the American population, and whether these factors are temporary is yet to be seen.

The Federal Reserve's recent Beige Book (essentially the FED's "bible") was released on September 9th and stated that business activity had downshifted this August and September because of consumer spending deceleration, COVID-19/Delta variant spread, major supply chain disruptions, and serious labor shortages (both skilled and unskilled) across the country. This release probably contributed to the September S&P 500 correction of 6%. The Beige Book's implications are that slow economic growth coupled with higher and intractable inflation can result in STAGFLATION. The Federal Reserve's toolbox is effective in modulating demand, however, with interest rates effectively at zero, demand has already been stimulated. Importantly, Federal Reserve policy choices cannot alter inflation caused by supply disruptions in U.S. ports, nor can it affect the increase in energy prices. Economic history of the 1970's and early 1980's talks of the pain of stagflation where Paul Volker, then Federal Reserve Chair, had to take interest rates to 15% (10-Year Treasury Bond on September 7, 1981) to break the stagflation condition. We do not expect the necessity for such drastic action this time however interest rates will have to rise (FMR expects the 10-Year Treasury Bond will to go to 3% to 4% from 1.7%) to avoid a more serious outcome to the economy.

THE FEDERAL RESERVE MUST TAKE STEPS TO BEGIN THE TAPER

The Federal Reserve should begin "tapering" (reducing) the $120B of monthly bond purchasing because that level of cash released into the system becomes inflationary. The Federal Reserve should set free the fed funds short-term money market rate (0%) to rise as a reflection of the free market and inflation, not a manipulated rate as currently is the case. The money supply is still not under control and growing over 12% per year. Common sense says that a government bond yield of 1.6% or 2% with inflation at 5% or even 3% to 4% is a ***negative real return***, not just a low return, but no return. This is unsustainable.

However, investors and FMR clients with long-term investment horizons will do well to continue taking and owning positions in common stocks, particularly companies with well-defined earnings prospects, pricing power, strong balance sheets, incentivized management teams, and most importantly, growing free cash flow!

FREE CASH FLOW (FCF) COMPANIES

Investors increasingly are recognizing that company FCF is a key indicator of future profitability and investment opportunities. Over the past 18 years, FMR has favored researching and buying dominant companies that generate FCF. Utilizing FCF in stock analysis provides a strong investment indicator and is better than using earnings per share (EPS) or earnings ratios for predictive measurement. Why? Accounting standards are not uniform from industry to industry or from sector to sector in calculating EPS. On the other hand, FCF is not subject to accounting options. FCF is the cash left after a company pays all production, materials, labor costs, taxes, and capital spending. FCF is not subject to manipulation depending on specific industry objectives. Rather, it is a measure of a company's liquidity and more valuable today in identifying companies that can outperform financially.

Companies' deployment of FCF is a strong indicator of management focus on creating value for shareholders. How company managements spend or invest this FCF is a more reliable and dependable metric for evaluating companies. Five Mile River client portfolios hold stock in companies that grow their dividends and buy back shares. Five Mile River portfolio managers also look to make investments for clients in companies with substantial FCF that make accretive acquisitions or consider mergers where one plus one equals three. These companies are less dependent on capital markets to finance growth and are less susceptible to totally unexpected events like COVID-19.

Five Mile River Portfolios are comprised of a large majority of FCF companies. Some of the Five Mile River portfolio holdings with FCF are well recognized names held in Five Mile River growth, balanced and income portfolios. Some stocks have been held for the long-term due to their commitment to FCF. A few of the well-known holdings with significant FCF are: Microsoft with $66B FCF; Johnson and Johnson with $12B FCF; American Tower with $4B FCF; Chevron with $20B FCF; Lockheed Martin with $5.8B FCF; Medtronic with $5B FCF; Raytheon with $6B FCF; Union Pacific with $4.4B FCF; Visa with $6B FCF to name a few. Five Mile River's focus on FCF for holdings in client portfolios is the most consistent long-term strategy of successful investing.

While this 3Q21 client letter emphasizes the current inflationary pressures, and provides a more in-depth discussion of company FCF, future client quarterly letters will continue to highlight individual companies held in FMR portfolios. We hope that this letter is a good explanation of the most significant of FMRs evaluation metrics for buying and holding certain high quality company stocks that will generate growth in portfolios.

We wish you a pleasant fall and a joyful holiday season. Please call or email Five Mile if you have any questions or thoughts on the information provided in this letter, or if you would like to discuss your portfolio holdings or plan a review.

Sincerely,

Lee Todd Martha

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**The S&P 500 Index is a market capitalized weighted index of 500 companies. It is a growth-biased index because the larger the capitalization of a company, the larger the weighting it contributes to the S&P 500 Index performance. The index referenced includes the dividends issued by these 500 companies. This index is used for a comparison for FMR accounts.*

The performance data included in this letter are not audited and have not been otherwise reviewed or verified by an outside party. While Five Mile River Investment Management, LLC endeavors to furnish accurate information, investors should not rely upon the accuracy or completeness of this information.

This letter is not meant as a general guide to investing, or as a source of any specific investment recommendation, and makes no implied or express recommendation concerning the manner in which any clients' accounts should or would be handled as appropriate investment decisions depend upon clients' investment objectives. Any offer to sell or the solicitation of an offer to buy any interests in any securities may be made only by means of delivery of a Five Mile River Investment Management Agreement and/or other similar materials which contain a description of the material terms and various considerations and risk factors relating to such securities or fund.   Different types of investments and/or investment strategies involve varying levels of risk, and there can be no assurance that any specific investment or investment strategy will be either suitable or profitable for a client's or prospective client's portfolio, and there can be no assurance that investors will not incur losses.

***Please remember to contact Five Mile River Investment Management if there are any changes in your personal/financial situation or investment objectives**. Please also advise us if you would like to impose, add or modify any reasonable qualifications to your investment portfolio(s).*